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Supreme Court, U.S.
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No. 94-1337

In The

Supreme Court of the United States

October Term, 1994

LIBERTY MUTUAL INSURANCE COMPANY,

Petitioner,

v.

CHEMSTAR, INC. AND NATIONAL UNION FIRE INSURANCE CO. OF PITTSBURGH, PA.,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals, Ninth Circuit

REPLY BRIEF

MICHAEL J. BRADY*
SUSAN H. HANDELMAN
ROPERS, MAJESKI, KOHN & BENTLEY
1001 Marshall Street
Redwood City, CA 94063
(415) 364-8200

GERALD V. WEIGLE, JR.
DINSMORE & SHOHL
255 East Fifth Street
Suite 1900
Cincinnati, OH 45202-3172
(513) 977-8200

Counsel for Petitioner

*Counsel of Record

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

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INTRODUCTION

Much of Chemstar's Opposition deals with its view of the facts of its coverage dispute with Liberty Mutual Insurance Company. Liberty will not reply in kind, although it has quite a different view of those facts. The *legal* issues which are the focus of these proceedings do not concern Chemstar's reaction to Liberty's coverage decision. Instead, the legal issues involve whether the manner in which the trial court proceeded misused procedural rules to improperly change substantive rights, and improperly allowed substantial punitive damages to be awarded against Liberty for making decisions, in the context of a complex commercial dispute, where even the court below admitted that decisional law (which the court chose not to follow) favored Liberty's position.

I.

THE TRIAL COURT'S SUA SPONTE BIFURCATION OF THE CASE TO DETERMINE ONE INSURER'S (LIBERTY'S) "BAD FAITH" IN A FIRST TRIAL ALTERED LIBERTY'S SUBSTANTIVE RIGHTS

Many of the observations Chemstar makes in its discussions of the bifurcation issue support Liberty's position more than they detract from it. Several times Chemstar emphasizes that under the governing California law an insurer's duty to defend must be assessed as of the time the claim is asserted against the policyholder. Chemstar makes this point to argue that Liberty was properly held obligated to defend Chemstar, but the point applies as strongly to Chemstar's direct insurer,

respondent National Union.[1] National Union had at least the same duty to defend the claims against Chemstar as Liberty, but it was absolved of its obligation solely because of the manner in which the trial court considered the issues. Had the trial court first held a "damages/duty to defend" trial as to National Union or all insurers in the case, instead of as to Liberty alone, some of the damages assessed against Liberty would have been awarded against National Union instead.[2] Rules of procedure cannot alter state-created substantive rights as they were allowed to do in this instance.

Chemstar argues that Rule 42(b) "is entitled to strong presumptive validity under *Hanna* . . . ," (Opposition ("Oppo.") at p. 11, n. 10) as though Liberty were attacking the validity of bifurcation generally. Chemstar misses Liberty's point. Bifurcation is often an appropriate procedural device under the right circumstances, but that

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[1] As noted in Liberty's petition, Liberty never insured Chemstar directly. Liberty insured Genstar Corporation, which owned the subsidiary which sold its lime business to the company that became Chemstar. The date of the sale was December 5, 1986, and Genstar instructed Liberty to cancel its coverage for the lime business as of that date. Chemstar purchased its primary coverage from National Union for almost three years after that, from December 5, 1986 until October 1, 1988.

[2] In Part III of its opposition Chemstar argues that there is no impermissible disproportion between the punitive and compensatory damages awarded against Liberty. Almost all of the compensatory damages assessed against Liberty in the Phase I trial related to Liberty's failure to defend Chemstar. To the extent a significant portion of these amounts are National Union's obligation, the punitive damages award becomes further suspect.

does not mean that it can be used to change parties' substantive rights and obligations among themselves. The two cases cited by Chemstar[3] as supporting the use of bifurcation here are inapposite, because both involved straightforward bifurcations of liability and damages. In neither case was there any concern that the substantive liability result was affected by the bifurcation. In the present case the bifurcation, coupled with the evidentiary rulings on what Liberty would be allowed to present to the jury during its bad faith trial, did have that effect, which is one reason the present case is deserving of review.

Chemstar is also wrong when it contends (Oppo. at p. 15) that Liberty's position is easily disposed of because duty to defend issues are often resolved prior to associated indemnity issues, and that "exactly parallels" what occurred here. No such parallel exists. Here the court moved from one insurer's duty to defend, to a bad faith damages trial respecting that insurer only, to coverage as to all parties. There is nothing inherently improper in considering duty to defend as to all insurers in a case separately from ruling on other coverage issues, and Liberty does not argue that there is. Where the court erred here was in selecting one of several insurers, Liberty, to stand trial on damages arising out of the duty to defend, to allow a jury to impose all compensatory and punitive damages and to impose all defense obligations on that one insurer before addressing "coverage issues." As a result of the strange way in which it compartmentalized

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[3] *Sellers v. Baisier*, 792 F.2d 690 (7th Cir. 1986); *Rosales v. Honda Motor Co.*, 726 F.2d 259 (5th Cir. 1984).

the parties and issues, the court both denied Liberty the right to present evidence that would undercut Chemstar's bad faith arguments, and applied a different duty to defend standard to Liberty than to National Union.

There are two responses to Chemstar's argument that Liberty is merely protesting evidentiary rulings by the trial court, and that Liberty had no right to have the jury consider irrelevant evidence. First, the evidence which the trial court refused to allow Liberty to present during the Phase I "damages/duty to defend" trial could be termed "irrelevant" only because of the strange bifurcation which the trial court adopted. Second, this evidence went to the heart of Chemstar's highly emotional bad faith argument to the jury during Phase I, which was what Liberty was trying to avoid a "big hit" on the plaster pitting cases, and needed to be punished severely to "send a message" to the company's management.

Chemstar is wrong in arguing that the result reached in this case can be reconciled with California law. (*See* authorities cited and discussed at pages 16-17 of Liberty's Petition.) California law holds that an insurer charged with bad faith is entitled to have the jury consider *all* of the circumstances pertinent to the insurer's conduct. That was not allowed to happen in the case at bar solely because of the manner in which the issues were bifurcated.[4]

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[4] Chemstar's argument at pages 12-13 of its Opposition – that the evidence Liberty was not allowed to present was properly excluded because Liberty's claims personnel did not rely upon these factors in deciding that the Liberty policies did not apply to Chemstar – misses the point. The evidence in question

II.

THIS COURT SHOULD REVIEW THE $14 MILLION PUNITIVE DAMAGES AWARD IMPOSED AGAINST LIBERTY

A. The Award of Punitive Damages in This Case Violates Due Process

Chemstar does not dispute that an award of punitive damages, in order to comport with due process under the U.S. Constitution, must be "reasonable" under the circumstances of that case. (*TXO Production Corp. v. Alliance Resources Corp.*, 113 S.Ct. 2711 (1993); Oppo. at p. 20.) Further, Chemstar cannot and does not dispute the basic character of the conflict in this case that gave rise to the imposition of punitive damages, *i.e.*, a dispute over whether insurance policies issued by Liberty to one company (Genstar) provide coverage to a different company (Chemstar) for claims that arose after the Liberty policies were cancelled by the insured.

An insurer's coverage decisions are based on facts concerning the claim, based on the express policy terms, and based as well on the relevant law. The factual context

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was that Liberty's limits of coverage were much more modest than the $40 to $50 million "hit" referred to by Chemstar, that under its policies with Genstar Liberty could charge back substantial premiums based on defense and indemnity expenses, and that Liberty was close to exhausting its coverage by handling the plaster pitting cases on behalf of Genstar and related entities in any event. Those facts naturally were not the basis for Liberty's coverage decision, but they strongly contradict Chemstar's (successful) argument to the jury that Liberty based its decision on improper financial considerations in the hope of avoiding Chemstar's mythic "big hit."

in which claims are presented is fluid. Examples of fluid facts affecting coverage in this case include the corporate changeover from Genstar to Chemstar (App. 76a) and express cancellation of coverage under the Liberty policies before the first suit (the Friedman lawsuit) arose. (*See*, App. 108a.) The legal environment is fluid as well. Cases are decided regularly that affect some aspect of coverage in virtually any large commercial dispute. For example, in the present case, although the precise trigger of coverage issue present here had not been addressed by the California courts, the Court of Appeals acknowledged that Liberty applied the "closest" case that had been decided. (App. 23a [9th Circuit acknowledged that *Whittaker Corp. v. Allianz Underwriters, Inc.*, 14 Cal.Rptr.2d 659 (Cal. App. 1992) is the "closest case" and arguably supports Liberty's coverage position].)

Liberty also followed valid case authority for its determination that Chemstar, which at no time purchased insurance from Liberty, did not *become* an insured by its involvement in a series of complicated mergers and acquisitions. (*Northern Ins. Co. of New York v. Allied Mutual Insurance Co.*, 955 F.2d 1353 (9th Cir. 1992); see also *Quemetco, Inc. v. Pacific Automobile Ins. Co.* 29 Cal.Rptr.2d 627 (Cal.App. 1994).) The Ninth Circuit brushed over these cases. (App. 27a.)

The question raised here is *not* whether this is a significant insurance dispute involving costly plaster disfigurement in various California homes. (*See* Oppo. at p. 19.) But the question raised by the multi-million dollar punitive damages award in this case, as in *BMW of North America v. Gore, cert. granted*, 63 U.S.L.W. 3555 (U.S. Jan. 23, 1995) (No. 94-896), is whether punitive damages can

be imposed in a commercial context where the punished party made reasonable decisions based on the law applicable to the underlying dispute.

Chemstar attempts to defend the reasonableness of the imposition of $14 million in punitive damages by referring to the wealth of Liberty. (*See, e.g.*, Oppo. at pp. 21, 22.) However, punitive damages that *result from* an insurer's declination of coverage based on its application of the "closest" existing law cannot be "reasonable" as defined in *TXO*. A $14 million dollar windfall to a substantial corporate insured (such as Chemstar) under theses circumstances does not become reasonable simply by pointing out that Liberty itself is a big company.

Chemstar's reliance on *Montrose Chemical Corp. v. Superior Court*, 24 Cal.Rptr.2d 467 (1993), *Horace Mann Ins. Co. v. Barbara B.*, 17 Cal.Rptr.2d 210 (1993) and *Gray v. Zurich Ins. Co.*, 54 Cal.Rptr. 104 (1966) – for the proposition that an insurer has a duty to defend an action whenever there is a potential for coverage – actually makes Liberty's point on the unreasonableness of punitive damages. It is also well established that an insurer may *decline* to provide coverage where the facts and the law show that the policy is inapplicable. Moreover, a dispute over legal issues concerning insurance policy interpretation, according to California law, cannot give rise to a duty to defend. (*State Farm Mutual Automobile Insurance Co. v. Longden* 142 Cal.Rptr. 726, 731 (Cal. App. 1987).)[5]

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[5] As set forth above, Liberty relied on valid case authority for declining coverage to Chemstar (*i.e.*, it relied on the "closest" case, *Whittaker, supra*, on the trigger of coverage issue, and on other cases such as *Northern, supra* and later *Quemetco, supra* for

Where an insurer, such as Liberty in this case, makes a coverage decision based on the law in existence at the time and the facts as known at the time, and where, as here, a court later *predicts* that the California Supreme Court will determine the *precise* issue involved in this case so as to implicate Liberty's policies, the denial of coverage cannot, as a matter of law, be determined to rise to the level of opprobriousness that would justify a punitive damages award of millions of dollars.[6]

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the proposition that Chemstar had no rights under policies purchased by – and cancelled by – Genstar. Even if Liberty and Chemstar had differing views of the legal effects of those cases, under *Longden* that dispute cannot give rise to a potential for coverage, much less a $14 million award of *punitive damages* resulting from such a scenario. Nonetheless, the Ninth Circuit panel expressly declined to follow *Longden*. (App. 29a, 41a.)

[6] Although divided on the matter, Liberty and Chemstar have informed this Court that cases are pending before the California Supreme Court at the present time which may determine whether the Ninth Circuit Court of Appeals' prediction regarding the ultimate coverage issue in this case is correct. (Petition at pp. 5-6; Oppo. at p. 5 [referring to pendency of *Montrose v. Admiral Ins. Co.* and *Stonewall Insurance Company v. City of Palos Verdes* in the California Supreme Court].) Oral argument has been scheduled in the *Montrose* case for April 5, 1995. A decision should be published within 90 days thereafter (Cal. Const., Art. VI, § 19) which may confirm or disaffirm the Ninth Circuit's prediction. Thus, we may know very shortly whether the $14 million dollar punishment inflicted on Liberty for its claims decision is not only unreasonable under the circumstances, but whether it is also fundamentally unjust because Liberty may have been right all along.

B. Liberty Was Not Afforded Meaningful And Adequate Review Of The Multi-Million Dollar Punitive Damages Award Assessed Against It

Chemstar does not deny, nor can it, that the trial court's review of punitive damages consisted of, at best, three conclusory sentences encompassed in the denial of post-trial motions. (App. pp. 78a-79a.) The trial judge merely stated that the punitive damages were supported by unspecified "evidence," that a punitive damages "instruction" was not in error "considering the instructions as a whole," and that the amount of punitive damages was related to actual damages. (App. pp. 78a-79a.) This stands in stark contrast to the analysis of punitive damages that was required by the Ninth Circuit pursuant to the due process clause in the U. S. Constitution in *Morgan v. Woessner*, 997 F.2d 1244 (9th Cir. 1993). The *Morgan* court ordered a district court to review a punitive damages award according to the seven specific factors and numerous sub-factors approved by the United States Supreme Court in *Pacific Mutual Life Ins. Co. v. Haslip*, 499 U.S. 1, 22-23 (1991) citing *Hammond v. City of Gadsden*, 493 S.2d 1374, 1379 (Ala. 1986).

The Court of Appeals' treatment of the multi-million dollar punitive damages award against Liberty is conceded to be likewise conclusory. (*See* Oppo. at pp. 22-23; App. 39a-40a.)

CONCLUSION

The punitive damages issues encompassed in *BMW of North America, Inc. v. Gore, supra*, pending before this

Court, are relevant to the punitive damages issues in this case. Fundamental to *BMW* is the question of whether a $2 million punitive damages award in a commercial context violates due process under the United States Constitution. In *BMW* the party against whom punitive damages were imposed complied with state law regarding repair of vehicles damaged in transit. Likewise, in this case, Liberty complied with applicable decisional law in making its coverage analysis. In *neither* case are millions of dollars in punitive damages "reasonable".

Certiorari should be granted here. At a very minimum, certiorari should be granted in this case pending the outcome of the *BMW* case before this Court. Certiorari should also be granted pending the outcome of the California Supreme Court's hearing in *Montrose* (n. 1, *supra*) bearing on the propriety of the District Court's prediction on the coverage issue giving rise to the punitive damages in this case.

Respectfully submitted,

DATED: March 17, 1995

MICHAEL J. BRADY*
SUSAN H. HANDELMAN
ROPERS, MAJESKI, KOHN
& BENTLEY

GERALD V. WEIGLE, JR.
DINSMORE & SHOHL
Counsel for Liberty Mutual
Insurance Company

* Counsel of Record
for Liberty Mutual
Insurance Company